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Economic Report

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Commentary on Pertinent Economic Issues

Irwin L. Kellner
Chief Economist

Picking Up The Pieces

Besides shattering many dreams and expectations, the stock market's crash has fragmented opinions on the outlook for the U.S. economy and what, if anything, the government should do about it—not to mention on the future course of stock prices, interest rates, and the foreign exchange value of the dollar. For every economist who says that the right policy prescription is for Washington to slash its budget deficit, there's another who warns that administering fiscal restraint at this time would risk a repetition of what happened in the 1930s. On the other hand, while many economists now believe that a recession is likely in 1988, there are more than a few who think that another year of growth is in store, and that the stock market's plunge will not prevent the expansion from continuing. Some applaud the drop in interest rates and the value of the dollar that occurred in the wake of the market's plunge as cushions against a possible recession, while others have become concerned that these developments are harbingers of a higher rate of inflation.

Here are some of the questions that have arisen in the wake of the market's crash:

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Did the stock market crash because of Washington's budget deficit?

The reasons for the market's crash are numerous and complex, and, no doubt, concern over the budget deficit was one of them. However, the budget picture was no different on Monday, October 19, than it was on the previous Friday—or, for that matter, all during the month. If anything, Washington's budget deficit in the 12 months ending September 30, 1987, fell to its lowest annual level since 1982. Not only that—both stock prices and the economy rose for five years straight, a period that coincided with rising budget deficits!

Then why all this talk about the need for the President and the Congress to cut the budget deficit?

The markets have become concerned about the fact that the United States for a number of years has been consuming more than it has been producing—and, in effect, borrowing from foreigners to finance this excess. According to this line of reasoning, a lower budget deficit will result in less Federal borrowing, which means less reliance on foreign funds. Interest rates can then move lower which will push down the value of the dollar and help reduce our trade deficit which will cushion us against a recession.

Aren't there risks in this strategy?

Sure, there are! For one thing, the deficit could be cut too sharply, resulting in more fiscal restraint than the economy could handle. For another, if the dollar goes down too rapidly, it will discourage even a reduced inflow of foreign funds—not to mention causing withdrawals. More inflation could arise from the lower-valued dollar as imported goods go up in price and domestic manufacturers use this as an opportunity to raise their own selling prices.

By reducing the value of the dollar in foreign exchange markets, isn't Washington, in effect, trying to export our recession to our trading partners, similar to the intent of the Smoot-Hawley Tariff Act of 1930?

First of all, the value of the dollar in foreign exchange markets is determined by more than Washington's wishes, so it is not all that clear that this is deliberate policy on our part. Secondly, if other countries were to respond by taking steps to counter the falling dollar, they would undoubtedly employ, among other strategies, a policy of reducing their interest rates. This would help them by stimulating their economies, while helping us by providing better export markets for us and for our trading partners.

Why all this worry about the strength of the U.S. economy? The latest statistics show that business was expanding at a pretty good clip before the market's plunge.

Storm clouds were gathering on the horizon well before the market's plunge in the form of a rise in the rate of inflation (which cuts into buying power), rising interest rates

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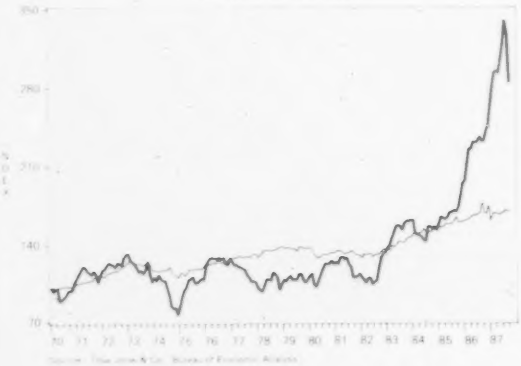
(which reduces borrowing power), and declines in auto sales and homebuilding, which, as you can imagine, affect a wide variety of industries. Keep in mind also that the stock market crash of October 19 did not represent a sudden reversal in the market's trend: stock prices began to slide nearly two months earlier. Lower stock prices reinforced the downward trend in spending by reducing both the wealth of those who are in the market, and the confidence of the great majority who are not, but who are aware of market trends.

But the surge in stock prices that took place between the beginning of the year and August 25 did not lead to a similar surge in spending, so why should the decline lead to a reduction in spending?

Spending levels might have been even lower if the stock market hadn't gone up earlier, since personal savings are low and debt usage is high. Many people looked upon the rising value of their stocks as a substitute for savings.

DOW JONES INDUSTRIAL AVERAGE (THICK) VS. REAL RETAIL SALES (THIN) (JANUARY 1970=100)



The stock market declined by about the same percentage in 1962, and yet there was no recession for over seven years, so why can't we avoid a recession this time?

There are many differences today compared with a quarter of a century ago. For one thing, the economic recovery then under way was about one year old, meaning that it was strong enough to withstand such a shock. This year's crash finds the expansion a senior citizen by business cycle standards. Indeed, when October came to an end, the expansion set a new record for peacetime longevity of 59 months—more than twice as long as average. Additionally, the 1962 stock market decline was spread out over a period of months, not concentrated in a few hours as this one was. Thus, it did not make the headlines in the newspapers, the cover stories of national magazines, nor did it receive the television treatment that this decline did.

In the wake of the fall in the value of the dollar, won't the drop in the trade deficit be enough to offset any softness in domestic spending?

One should not expect too much from a declining trade deficit for several reasons: First, our trade position almost always improves when the U.S. economy is in a recession, since reduced consumption levels in general also lead to fewer imports. Second, exports represent only about 11 percent of gross national product, thus are unlikely to offset massive weaknesses elsewhere. And exports may not rise much this time because our trading partners are either growing slowly themselves, or have restricted the inflow of foreign goods to improve their own balance of payments.

As you know, the stock market crash led to a drop in interest rates. Why wouldn't this tend to prevent a recession—especially considering that bonds, whose prices went up as interest rates fell, are widely held?

Let's take the second part first. Even after the crash, the value of stocks still exceeds the value of bonds. In addition, stocks at mid-November were about 28 percent below their August peaks, while bond prices were up only about eight percent. Households own a greater percentage of stocks outstanding than they do bonds. Thus, the drop in the value of household-owned stocks from their peak in August (over $750 billion) far outweighs the increase in the value of household-owned bonds (about $75 billion) that occurred in the wake of the drop in interest rates beginning on October 19. As for the decline in interest rates themselves, while this might make it easier for people to borrow, it is not all that clear that they will want to borrow until they see how their

financial situation will be affected by the stock market's crash.

But shouldn't the rise in bond prices, along with the drop in interest rates—not to mention the reduced concern over inflation that has followed in the wake of the market's crash, be considered good news for the economy which should be factored into the outlook?

There is no doubt that these developments are good news. However, past experience has shown that bad news affects the economy before good news does, and that sudden, unexpected events, such as a stock market crash, can have a pretty rapid impact. For example, the drop in oil prices between October 1985 and April 1986 was good news for those who consume energy but bad news for those who produce it—and it was the production side that reacted first by cutting back output, thus holding down overall economic growth. In early 1980, the credit controls imposed by the Federal Reserve were widely misunderstood and led to an immediate downturn in consumer spending, thus plunging the economy into recession. And the oil embargo and quadrupling of oil prices that took place in October 1973 caused the economy to go into recession barely two months later.

If we do have a recession in 1988, is it conceivable that it could turn into something really bad?

We don't anticipate anything like the economic catastrophe that occurred after the 1929 crash. For one thing, the government is a much bigger factor today, and while many complain about the government, it helps stabilize economic activity in times like these. There are income maintenance programs such as Social Security and unemployment insurance that keep consumers' purchasing power from collapsing as it did in the 1930s. There are also many legal and regulatory safeguards that will keep confidence in our financial system, besides the fact that the market today is dominated by big institutional investors who are better able to deal with steep downturns.

After the experience of the 1930s, we learned that the government should rely primarily on fiscal policy to stimulate the economy, since monetary ease, by itself, did not seem to be able to do the job. Yet, this time around, we are faced with the loss of this fiscal tool, since, in today's environment, the government could not deliberately increase its budget deficit. That being the case, is there a risk that we will be unable to come out of recession relatively soon?

Notwithstanding the lessons of the past, today's circumstances dictate a *reduction* in Washington's budget deficit for reasons noted earlier: Less government borrowing means lower interest rates, lower interest rates will let the dollar drift lower and, that, in turn, will reduce our trade deficit, providing a cushion against a long recession. However, I would add that it is more important for the politicians to develop a credible long-range plan to reduce the deficit than it is to take a big chunk out of the deficit for the current fiscal year.

Is there anything else we should have learned from the market's debacle?

Yes. Panic is a condition experienced by many living creatures. In the case of fishes, birds and animals, panic can start with a sudden disturbance to the environment. A herd of animals may be scared into panic by a shotgun blast; for man, the causes are more complex. We have had many panics in recorded history, the most famous of which, besides the market crash of October 1929, was probably the rapid rise and then plunge of the price of tulip bulbs in Holland during the first third of the seventeenth century.

Looking back over the accounts of the stock market's activity in the months and weeks leading up to the crash, one factor to consider is the role of the media. In the days and weeks prior to the crash, it was not uncommon to find in the financial press a comparison of the pre-crash declines with past history. It seems to me that this focused investors' attention on the relative importance of each major downward move in stock prices until one day, October 19, most came to the same conclusion that the time had come to get out. While this kind of reporting sells newspapers and magazines, unfortunately, it also sells stocks. ■

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